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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1975

No. 75-297

In the Matter of ARTHUR CLARKE AHLSWEDE and DOROTHY AHLSWEDE,
Bankrupts.
RICHARD W. STEBBINS, Trustee,
Petitioner,
v.
CROCKER-CITIZENS NATIONAL BANK,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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OF COUNSEL

DATED: August, 1975.

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IN THE

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No. _____

In the Matter of ARTHUR CLARKE AHLSWEDE and DOROTHY AHLSWEDE,

Bankrupts.

RICHARD W. STEBBINS, Trustee,

Petitioner,

v.

CROCKER-CITIZENS NATIONAL BANK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioner respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on April 29, 1975.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit, not yet reported, appears in the Appendix hereto. The unreported order on review of the District Court for the District of Nevada also appears in the Appendix, as does the Order of the Referee in Bankruptcy.

JURISDICTION

The judgment of the Court of Appeals was entered on April 29, 1975. Petitioner's application for an extension of time in which to file this petition was approved by order of this Court of July 28, 1975 granting an extension until August 27, 1975. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Where the allowance of the claim of the trustee of a spendthrift trust against a bankrupt estate will result solely in augmenting the bankrupt's beneficial interest in that trust, may the claim be subordinated to those of the other general creditors?

STATEMENT OF THE CASE

Bankrupt was one of four children designated

by their father as co-equal beneficiaries of a spendthrift trust established March 6, 1962. Under the trust instrument income was to be paid to the beneficiaries and the corpus was to be distributed in installments with the final distribution occurring ten years after the death of the settlor. If any beneficiary became indebted to the trust, that indebtedness was required to be satisfied out of any such distributions. The settlor died March 20, 1969. At the time of bankruptcy bankrupt was indebted to the trust on account of several notes executed on behalf of his father and donated by the latter to the trust prior to his death, and on account of a bank loan which had been paid by the trust as bankrupt's guarantor. There was no indication that the total amount of indebtedness exceeded the bankrupt's share of the trust assets.

During the bankruptcy proceedings, Respondent as trustee of the spendthrift trust asserted a claim as an unsecured creditor for the amount of bankrupt's indebtedness to the trust. The trustee objected to the claim but the referee held that it represented a legitimate debt and was

therefore provable; (Order of the referee Pg. A-3) However, the referee noted that to the extent that the bank trustee shared in a dividend, the bankrupt's debt to the trust was reduced and his future distributive share thereby enlarged. Since the trust instrument requiring set-off of any remaining indebtedness was not affected by bankrupt's discharge, this worked to the prejudice of the other general creditors who could not share in the trust assets since, being exempt from creditors, they did not become a part of the bankruptcy estate. To avoid what he characterized as an inequitable result, the referee exercised his equitable powers conferred by § 2(a) of the Bankruptcy Act, 11 U.S.C. § 11, to subordinate the claim of the Respondent to those of the other general creditors.

The District Court on review, while noting "the inequity--even iniquity" of this situation and agreeing with the reasonableness of the referee's order (District Court Opinion A - 10,12) nonetheless concluded that there was no law to support it and that the result was one which the the Bankruptcy Act "contemplates and permits."

On appeal to the Court of Appeals for the Ninth Circuit, that court agreed with the District Court's reversal of the referee's order on the grounds that the traditional bases for the application of the doctrine of equitable subordination did not exist.

REASONS FOR GRANTING THE WRIT

This case presents an important question of first impression in the administration of the Bankruptcy Act. At issue is the extent of a bankruptcy court's equitable power to subordinate a creditor's claim against the bankruptcy estate in these unique circumstances. Petitioner believes that to allow the decision of the Court of Appeals to stand will be to sanction an interpretation of the Act and to encourage a result which is inconsistent with the broad purposes and goals of the Act itself.

The law of bankruptcy as it first developed in England was intended to afford a method for the seizure of the debtor's assets in order that they might be equitably distributed among his creditors. Kuehner v. Irving Trust Co., 229 U.S. 445 (1936). While the concept was subsequently

broadened to embrace the discharge of an embarrassed debtor from antecedent debts, a primary purpose of bankruptcy legislation continues to be the conservation of the estates of insolvents to the end that there may be as equitable a distribution of the assets as is consistent with the types of claims involved. Simonson v. Granquist, 369 U.S. 38 (1961). Fairness to all persons having claims against an insolvent is an important statutory objective. Reading Co. V. Brown, 391 U.S. 471, 477 (1967).

In administering the Bankruptcy Act the bankruptcy court is a court of equity and is guided by equitable doctrines and principles except insofar as they are inconsistent with the Act. Securities and Exchange Commission v. U.S. Realty and Improvement Co., 310 U.S. 434, 455 (1940). There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction. Bank of Marin v. England, 385 U.S. 99, 103 (1966). Moreover, the Act is to be sensibly construed with a view to effectuating its purposes and policy, and not so narrowly as to defeat the true intent of

Congress. Simonson, supra. Nor will the Court adopt a construction of a provision in the Bankruptcy Act which would permit the bankrupt to experiment with the statute. Birkett v. Columbia Bank, 195 U.S. 345 (1904).

In the case at hand, the referee and the District Court were unanimous in decrying the inequity resulting from allowance of Respondent's claim on an equal basis with the others. Order of the referee A-5. and District Court Opinion A-10. Nor did the Court of Appeals appear to dissent from this view. As revealed by the facts, the only party shown to benefit from the allowance of the claim was the bankrupt himself. No harm was demonstrated to the trustee of the trust or to the other beneficiaries. On the other hand, the other general creditors were clearly prejudiced by their inability to share in the assets of the trust which under state law were exempt.

While the exemption policy is entitled to recognition in bankruptcy, the inequity is particularly apparent where the bankrupt has had access to the supposedly shielded trust assets

in the form of loans. Since the design of a spendthrift trust is to protect the beneficiary from his own improvidence by placing the assets beyond his reach and the reach of his creditors, to maintain the shield against those creditors where the spendthrift has in fact had the full use and enjoyment of the principal is to exalt form over substance. In short, no clearer case can be imagined calling for the application of the bankruptcy court's equitable powers than to prevent this unjust enrichment of the bankrupt at the expense of his general creditors in a manner which could hardly have been contemplated by Congress in the light of the broad aims and purposes of the Bankruptcy Act.

Nonetheless, the order of the referee subordinating the claim of the trustee of the trust was reversed because neither the District Court nor the Court of Appeals could find authority in the judicial precedents of this Court for such an order. Petitioner believes that this holding would be reversed by the Supreme Court on review for two reasons:

1. The precedents cited by the Court of

Appeals as foreclosing application of the doctrine of equitable subordination to this case are clearly distinguishable. None of those cases are analogous to the present situation where the trustee of a spendthrift trust has attempted to prove a claim in the bankruptcy of a beneficiary who is indebted to the trust, and where the sole party to benefit from the allowance of that claim is the bankrupt himself.

2. In attempting to draw an analogy to the prior cases the Court of Appeals ignored the most basic characteristic of equity jurisprudence, its ability to adapt itself to new situations whenever equitable remedies are called for. See Pomeroy, Treatise on Equity (5th ed. 1941) § 109. As noted by this Court in Securities and Exchange Commission v. Chenery Corp., 318 U.S. 80, 89 (1942), "Determination of what is fair and equitable calls for the application of equitable standards to particular sets of facts. But these standards are not static. In evolving standards of fairness and equity, the Commission is not bound by settled judicial precedents." The bankruptcy courts have exercised their

equitable powers "on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." Pepper v. Litton, 308 U.S. 295, 304 (1939). "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate." Pepper v. Litton, supra at 308. In short, "the equitable power is ample for the exigencies of varying situations...it inheres in the jurisdiction of a court of bankruptcy." American United Mutual Life Insurance Co. v. City of Avon Park, 311 U.S. 138, 146 (1940)

Petitioner believes that in placing fixed and rigid limits upon the exercise of the equitable powers of the bankruptcy court, the Court of Appeals has seriously hampered the administration of the Bankruptcy Act. To allow that decision to stand is to sanction and encourage the use of spendthrift trusts and possibly other

arrangements as a means of unjustly enriching the bankrupt at the expense of his general creditors thereby defeating the aims and purposes of the Act. By using a trust instrument modeled on the one in this case, the settlor of a trust may now not only protect the beneficiary from the claims of his creditors but may at the same time confer virtually all the benefits of outright ownership of the trust assets by advancing loans out of the trust principal, with the added and crowning benefit of thereby ensuring that the trustee may compete on an equal basis with the spendthrift's other creditors in the event of his subsequent bankruptcy! Such abuse will tend to seriously undermine the integrity of the bankruptcy process in a manner which could not have been intended by Congress.

The pattern presented here is to neat. It offers too much encouragement to widespread flagrant abuses with hardship resulting to multitudes. In a projected case, three hundred thousand dollars ($300,000.00) is borrowed from a spendthrift trust over a period of years for living expenses which, with interest thereon of two hundred thousand dollars ($200,000.00)

creates five hundred thousand dollars ($500,000.00) in loans to the beneficiary by the trust. The sum of two hundred fifty thousand dollars ($250,000.00) is then borrowed for a business venture and two hundred fifty thousand dollars ($250,000.00) is obtained from trade creditors. The business does not develop the desired level of profitability and is sold for five hundred thousand dollars ($500,000.00) and the beneficiary of the trust files bankruptcy.

One would think that the creditors would come out whole. Not so, if the decision of the Ninth Circuit Court of Appeals is allowed to stand. The bank trustee enters a claim for seven hundred fifty thousand dollars ($750,000.00); the creditors enter a claim for two hundred fifty thousand dollars ($250,000.00), the sale of the assets for five hundred thousand dollars ($500,000.00) means a distribution to the creditors of 50%. The beneficiary of the trust carries back three hundred seventy five thousand dollars ($375,000.00) to his trust through the bank trustee, thus enriching himself one hundred twenty-five thousand dollars ($125,000.00) at the expense of his creditors.

Indeed, the opinion of the Court of Appeals is already receiving national comment. See for example the July 15, 1975 issue of Board Room Reports, published in New York City, which comments at page 5 that "this device might be of use by an individual planning to set up a family member in a new business involving significant risk."

Review of the decision of the Court of Appeals is indicated as subordination of the trustee's claim appears the simplest, most logical, consistent and flexible remedy for this situation. It may indeed offer the only remedy, as the Court of Appeals noted, See their Opinion, A-16, 17.

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari be granted.

Respectfully submitted,

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Of Counsel

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEVADA

In the Matter of:	)	IN
ARTHUR CLARKE AHLSWEDE	)	BANKRUPTCY
and DOROTHY AHLSWEDE,	)	BK-R-71-198-
Bankrupts	)	199

ORDER RE CROCKER CITIZENS NATIONAL BANK TRUSTEE UNDER ARTHUR CHARLES AHLSWEDE TRUST, CLAIM NO. 37

At Reno, in said district, this 9th day of February, 1973.

The trustee objected to Claim No. 37 of Crocker Citizens National Bank as trustee under a trust created by the father of the bankrupt.

The parties have stipulated to certain facts. The Court finds as fact:

1. A spendthrift trust was created by bankrupt's father March 6, 1962 which upon his death was to be divided into equal shares to be separate and independent trusts for each of his living children or the children of a deceased child by representation. The trustor died March 20, 1969; he had four children including bankrupt. At the present the trust consists of substantial holding of securities, notes receiveable and miscellaneous interests. Due to disputes among the four beneficiaries the trust was not actually divided into four separate trusts by the trustee upon the death of the trustor.

2. By various loans on notes to either the Crocker Citizens Bank with trust assets pledged to repay (and which has been paid by the trust to

the bank) or loans on notes directly to his father, assigned to the trust, there is due the trustee a balance of the loans plus interest.

3. Each of the trusts for the four children of the trustor owns one-fourth of the total assets of the trust. The debt due from the bankrupt is owned one-fourth by his trust and three-fourths by the trust of his three sisters.

4. The trustee bank has the right to resort to distributions to the bankrupt from his trust. It has applied a distribution March 20, 1970 and is applying regular income distributions. It is entitled to set-off against distributions to the bankrupt due to be paid three years after the death of the trustor, one-third on March 20, 1973, seven years after the death of the trustor March 20, 1976 and the balance remaining ten years after the death of the trustor March 20, 1979.

5. If the bankrupt is not living on the dates of distribution then the set-offs may be made against his representatives or heirs for whom the bankrupt's trust continues.

6. The obligation to the trust from the bankrupt consists of four loans and a deficiency balance of a loan foreclosed guaranteed by the trust. The total of the claim was stipulated as follows:

Note 9/1/64	$14,593.79	Interest 5%
" " " "	1,504.35	" "
" " " "	24,350.00	" 4%
" " " "	7,203.96	" "
Balance due a/c foreclosed loan guaranteed by trust	$21,975.82	

The latter obligation was reduced to its present balance by distribution of $27,094.26 as the bankrupt's interest on March 20, 1970 and further monthly distributions totaling

$9,359.46 between 5/6/70 and 12/5/72.

CONCLUSIONS OF LAW

1. The trust of Arthur Charles Ahlswede dated November 14, 1963 as amended February 24, 1965 is a spendthrift trust under California law and not subject to the claims of the bankrupt's creditors. In re Edward's Estate, 17P. 2d 116; In re Laurence's Estate, 72 Cal Reptr 851. The bank trustee holds exempt property which the trustee in bankruptcy cannot reach.

2. The claim is for a legitimate debt in fact and law and the bank trustee is a creditor. A creditor under Section 1(11) of the Act is anyone who owns a debt or demand. The bank trustee cannot be disenfranchised in its rights as a creditor under Article VIII, para. (5) of the Trust by an Order of this Court which might affect its right and duty to satisfy payment of notes or debts from future distributable shares due the bankrupt.

3. The discharge of the bankrupt does not affect the terms of the trust instrument. The Bankruptcy Court has no jurisdiction over exempt property nor the terms of the Trust Agreement. Nonetheless, it is readily apparent that there may be a windfall to the bankrupt in this:

(1) To the extent that the bank trustee shares in a dividend from this estate the debt of the bankrupt to the trust is thereby reduced and the bankrupt or his heirs gain a larger distribution from the trust.

(2) Such amount which reduces the bankrupt's debt to the trust enures to the benefit of the bankrupt at the expense of general creditors who cannot reach the trust assets.

It is therefore a situation for equity so as not to injure one creditor's rights but at the same time not to benefit one creditor at the expense of others. Nor is it fair to allow the bankrupt to wholly discharge the debt to the trust.

And it is not fair and equitable for the bankrupt to have his debts paid into one pocket of the trust and then be entitled to the benefits of the spendthrift provisions and protection from general creditors.

I hold that I cannot interfere with the Trust. Future payments or distributions to the bankrupt are, under California law cited by the Bank, not reachable by the Trustee in Bankruptcy or the creditors. Therefore, I cannot hold that after the Trust is reimbursed future payments exceeding the indebtedness would be payable to the general creditors. Such order would violate the terms of the trust and the law of California. Monies distributable to the bankrupt from the Trust are exempt from creditors now and forever except the Bank Trustee has the right and duty to apply distributable protions to satisfy the payments of notes of the bankrupt held as assets of the trust.

I further hold that while the Bank Trustee is a creditor, the discharge of the bankrupt does not in any way modify the terms of the trust instrument so as to deny the Bank Trustee the right and duty to carry out the terms of the trust by application of distributable portions payable to the bankrupt to satisfaction of the notes due to the trust as assets. Nevertheless, the discharge is effective as to the bank's right to recover from the bankrupt except as provided in the trust instrument by application of distributable portions.

The trust has the advantage of the spendthrift trust provisions. But the trust cannot have its cake and eat it, too. The trustor protected the bankrupt from the latter's creditors. At the same time the trustor protected the trust by requiring loans made to the bankrupt beneficiary to be satisfied out of distributions to be made in the future.

It would be inequitable for the trustee of a spendthrift trust to collect from the bankrupt beneficiary's estate in bankruptcy and then distribute to the bankrupt free of creditors' claims.

The Bank Trustee is entitled to collect the debt due from the bankrupt but the Court cannot permit the trust to be a shield from general creditors to the advantage of the bankrupt while giving the Bank Trustee the same status as a general creditor. The trust instrument is a family affair exclusive of the bankrupt's general creditors. This bankruptcy is a public affair wherein general creditors must be treated equally. It is not necessary that there be fraud or other inequitable conduct. Costello v. Fazio, 256 F 2d 903.

It is sufficient that there is inequity in this situation. True, there are numerous cases wherein stockholders in a corporation have been allowed to claim equally with general creditors for loans where funds were advanced with reasonable expectation of repayment. 51ALR 2d 989 at 992. See also 15 Vanderbilt law Review 83: Herzog and Zweibel "The Equitable Subordination of Claims in Bankruptcy". But in none of those cases was there a power to deny general creditors recourse to the assets of the corporation. While the Ahlswede Trust is a legal entity and its eventual full recovery is contingent upon

the dates of distribution to the bankrupt or his heirs, it is clothed with protection from the very persons with whom it seeks to share the dividends of the bankruptcy assets. It is the vehicle through which the bankrupt or his heirs enjoy creditor-free distributions. The bankrupt's heirs should not be entitled to any benefits which the bankrupt himself deprived them by loans at the expense of his creditors. The trust cannot be permitted to participate to the possible benefit of the bankrupt under the guise that it is not an alter ego. It was certainly designed to protect the bankrupt from his creditors. Now in good conscience the trust cannot be permitted to share equally with them what other assets may be availabe.

Section 100.040 Nevada Revised Statutes provides: "Where a creditor is entitled to resort to each of several funds for the satisfaction of his claim, and another person has an interest in, or is entitled as a creditor to resort to some, but not all, of them, the latter may require the former to seek satisfaction from those funds to which the latter has no such claim, so far as it can be done without impairing the right of the former to complete satisfaction, and without doing injustice to third persons."

Obviously the Crocker Citizens Bank as trustee is both seeking resort to the bankruptcy fund and is also entitled to set-off its claims against distributions to the bankrupt. It would appear that justice and equity require that the Claim No. 37 of the Crocker Citizens Bank as trustee of Ahlswede Trust be allowed but subordinated to the claims of general creditors.

IT IS SO ORDERED.

Bert Goldwater
Referee in Bankruptcy

cc: Bruce Roberts, Esq.
Richard Stebbins
Richard Horton, Esq.
Richard Clements, Esq.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEVADA

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In the Matter of:)IN BANKRUPTCY
ARTHUR CLARKE AHLSWEDE)NO. BK-R-71-198
and DOROTHY AHLSWEDE,)NO. BK-R-71-199
Bankrupts.)

ORDER ON REVIEW

The claim of Crocker-Citizens National Bank against the Bankrupt's estate is secured by the Bankrupt's distributive share of a spendthrift trust created by Ahlswede's father. Crocker asserts the claim against the estate is an unsecured claim entitled to share ratably with the general creditors of the Bankrupt.

The California spendthrift trust in question is in the usual form and provides that the interests of the beneficiaries in principal and income shall not be subject to the claims of their creditors and may not be voluntarily or involuntarily alienated or assigned. This provision is entitled to enforcement under California law. In re Edwards Estate, 17 P. 2d 116; In re Laurence's Estate, 72 Cal. Rptr. 851; Kelly v. Kelly, 11 Cal. 2d 355, 79 P. 2d 1059. The Bankrupt's distributive share of the income and principal of such a trust is not a part of his estate in bankruptcy. Restatement of Trusts 2nd, §§149, 152; Danning v. Lederer, 232 F. 2d 610 (7th Cir. 1956).

The Referee concluded that his equitable powers in the premises should be applied and ordered that the Crocker claim be subordinated to the claims of the general creditors.

Crocker, on review of the order, contends (1) that its claim is unsecured within the meaning of the Bankruptcy Act; (2) that a claim cannot be subordinated without a showing of fraud or inequitable conduct; and (3) that there is no assurance that the Bankrupt's obligation to Crocker will be paid from his distributive share of the spendthrift trust.

The several promissory notes comprising Crocker's claim fall into two classes. The first $50,000 note evidenced a loan by Crocker to the Bankrupt which was specifically secured by an assignment by the trustor of all the assets of the trust. On September 31, 1972, a principal balance of $22,292.74 remained unpaid on this obligation. The remainder of the claim is based on several promissory notes evidencing loans made by the trustee personally to the Bankrupt. These notes were donated by the trustor to the trustee as additions to the trust estate. The trust instrument provides that if any of the children of the trustor (beneficiaries) are obligated to the trust at the time such child's share would otherwise be available for distribution, such distributable portion shall first be applied to satisfy the obligation.

On March 20, 1969, the trustor died. The Bankrupt thereafter has been entitled to one-fourth of the net income of the trust. Under the declaration of trust, the Bankrupt's share of the principal of the trust estate is to be distributed as follows: One-fourth thereof one year after trustor's death, one-third of the remainder four years after trustor's death, one-half of the remainder seven years after trustor's death, and the balance ten years after trustor's death. If a beneficiary dies before a distributive share is

payable to him, a gift over of his remaining share of the trust estate is made to the beneficiary's then living issue.

All income and the distributive share payable to the Bankrupt on March 20, 1970 have been applied to the Bankrupt's obligation to the trust. Presumably, the distributive share payable March 20, 1973 was also so applied.

The undersigned shares the Referee's concern over the plight of the Bankrupt's unsecured creditors in these circumstances. Equity would seem to require that Crocker Bank exhaust the security which it has before sharing in whatever other assets the trustee in bankruptcy may acquire. The inequity - even iniquity - of permitting Crocker to take a ratable share of any bankruptcy distributions to the general creditors with the possible theoretical consequences of preserving for the Bankrupt a distributive share of the spendthrift trust seems evident. It, nevertheless, appears clear that this is a result which the Bankruptcy Act contemplates and permits.

In the first place, the Crocker claim is not a secured claim. A secured claim is a claim of a creditor "who has security for his debt upon the property of the bankrupt of a nature to be assignable under this title" (11 U.S.C. 1(28)). The Bankrupt's interest in the spendthrift trust is not part of the estate in bankruptcy and is not assignable. Kelly v. Kelly, supra. The Crocker claim was properly filed as an unsecured claim. Ivanhoe Bldg. Assn. v. Orr, 295 U.S. 243 (1935). A creditor who has security on property which is not the property of the Bankrupt is not a secured creditor. The unfairness of this rule has been the subject of comment. Collier on Bankruptcy, 14th Ed., § 57.07.

It is also clear that the Bankruptcy Act vests jurisdiction in the Bankruptcy Court to subordinate a creditor's claim to those of others "in the light of equitable considerations." Pepper v. Litton, 308 U.S. 205 (1939). This does not, however, vest the Court with power to adjust and order claims merely because of a general feeling of what is fair and unfair. "Its (a claim's) disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence." (Emphasis added.) Pepper v. Litton, supra. These include relief from fraud, overreaching, breach of fiduciary relationships and the like. Cf. Sowell v. Federal Reserve Bank, 268 U.S. 449 (1925); Prudence Corp. v. Geist, 316 U.S. 89 (1942).

The case of Costello v. Fazio, 256 F.2d (9th Cir. 1958), relied upon by the Trustee, is not different. There the Court found that the subordinated creditors who were in a fiduciary relationship with the bankrupt corporation had, for their personal benefit, stripped the business of eighty percent of its stated capital in the face of substantial business losses to the obvious prejudice of the trade creditors.

In the instant case, there is no evidence of fraud or any inequitable conduct on the part of anyone with respect to the claims asserted by Crocker. The unfairness is in the Bankruptcy Act itself which ignores security on property not the assignable property of the bankrupt. The inequity to other creditors arises from the law's recognition of the validity of spendthrift trusts.

The only equitable principle upon which the Referee relied was the equitable doctrine of marshalling of assets. This doctrine may be applied where there are two or more creditors who seek

satisfaction from one debtor and one of the creditors can reach two funds held by the debtor, whereas the other creditor can reach only one of the funds. Unfortunately, research has disclosed that the doctrine is not applicable on these facts. It is not applicable to assets exempted by state law from levy by creditors. Meyer v. United States, 375 U.S. 233 (1963). Further, it has been held that a debtor's assets will not be marshalled unless this can be done without risk to the creditor. Victor Gruen Associates, Inc. v. Glass, 338 F.2d 826 (9th Cir. 1964). In the instant case, there is no assurance that the Bankrupt will not die before the spendthrift trust is fully distributed and thus no assurance that Crocker's security for payment of the obligation is adequate.

While I believe the Referee's order was a reasonable one under all the circumstances, I cannot find the law to support it. Accordingly,

IT HEREBY IS ORDERED that the decision of the Referee in Bankruptcy subordinating the claim of the Crocker Bank to the claims of the general creditors is hereby reversed.

Dated: April 26, 1973.

/s/ BRUCE R. THOMPSON
UNITED STATES DISTRICT JUDGE

JUDGMENT

United States Court of Appeals

FOR THE NINTH CIRCUIT

In the matter of ARTHUR CLARKE AHLSWEDE and DOROTHY AHLSWEDE, Bankrupts.

RICHARD W. STEBBINS, Trustee,

Appellant,

v.

CROCKER CITIZENS NATIONAL BANK,

Appellee.

No. 73-2506

DC# BK-R-71-198
BK-R-71-199

APPEAL from the United States District Court for the NEVADA (Reno) District of

THIS CAUSE came on to be heard on the Transcript of the Record from the United States District Court for the District of NEVADA

and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is AFFIRMED.

A True Copy
Attest 4/30/75

Emil E. Melfi, Jr., Clerk
by Ray Hewitt
Ray Hewitt, Senior Deputy

Filed and entered April 29, 1975

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In the Matter of:	)	
ARTHUR CLARKE AHLSWEDE	)	
and DOROTHY AHLSWEDE,	)	
Bankrupts.	)	
RICHARD W. STEBBINS,	)	No. 73-2506
Trustee,	)	
Appellant,	)	OPINION
vs.	)	
CROCKER CITIZENS	)	
NATIONAL BANK,	)	
Appellee.	)	
	)	

Appeal from the United States District Court for the District of Nevada

Before: CHAMBERS, KOELSCH and KILKENNY, Circuit Judges.

KOELSCH, Circuit Judge:

This case presents a unique question regarding the extent of a bankruptcy court's equitable power to subordinate a creditor's claim against the bankruptcy estate.

Bankrupt is one of four beneficiaries of a so-called "spendthrift" trust created inter vivos by his father. The trust instrument provides that "[t]he interests of all beneficiaries other than the Trustor in principal or income shall not be subject to claims of their creditors or others nor to legal process and may not be voluntary [sic] or involuntary [sic] alienated or encumbered." The trust situs is California;

California law enforces such trust provisions. See Kelly v. Kelly, 11 Cal. 2d 356, 79 P. 2d 1059 (1938); Cal. Civ. Code § 867. But see Cal. Civ. Code § 859; II Scott on Trusts §152. 1, at 1143 and n. 21 (3d ed. 1967); Comment, Trusts: Spendthrift Trusts in California: Civil Code Sections 859 and 867: Planning and construction of Spendthrift Provisions, 40 Cal. L. Rev. 441, 442 (1952). The effect of the trust provision is that upon the bankruptcy of the beneficiary his equitable interest in the income and principal of the trust estate, being non-assignable and immune from judicial process under California law, does not pass to the trustee of the bankruptcy estate, under Section 70(a)(5) of the Bankruptcy Act, 11 U.S.C. § 110(a)(5), and title remains in the trustee of the spendthrift trust. 1/ See 4A Collier on Bankruptcy ¶ 70. 26 at 364-71 (rev. ed. 1971); Restatement of Trusts 2d §§ 149, 152 (1959); Danning v. Lederer, 232 F. 2d 610 (7th Cir. 1956); Scott, supra, §152. 2, at 1150-51.

The claimant in this bankruptcy proceeding is the Crocker National Bank (Bank), the trustee of the bankrupt's spendthrift trust, claiming on behalf of the trust. The Bank's claim derives from a number of promissory notes, held as assets of the trust, evidencing loans made to the bankrupt at various times either by his father or the Bank, and now due the trust.

The trust instrument sets up a plan for equal periodic distributions of the income and principal of the trust to the four beneficiaries. It also provides that if a beneficiary is indebted to the trust when a distribution is scheduled, his distributive portion must first be used to offset his indebtedness. All of the bankrupt's shares

of trust income and principal have heretofore been applied to discharge his obligations to the trust, and several distributions remain to be made.

However, in this proceeding the Bank seeks to have the remaining indebtedness immediately discharged (insofar as possible) by allowing the trust to share in the bankruptcy estate on a parity with the general creditors. The ultimate effect of such a recovery by the Bank for the trust will be, of course, that the bankrupt's obligations to the trust will be diminished by reducing the shares going to general creditors, and the share of the trust which the bankrupt will ultimately receive will increase.

The trustee in bankruptcy objected to the claim, but the referee allowed it as provable, apparently concluding that the notes reflected bona fide debts rather than anticipatory distributions of the bankrupt's share of the trust estate.[2] However, the referee subordinated the Bank's claim to those of the other creditors. The referee justified his exercise of his general equitable powers on the rationale that it was unfair that the spendthrift trust should insulate the bankrupt's beneficial interest in the trust from the general creditors but that the trust should share with the creditor's in the bankrupt's other assets, thereafter distributing assets in an equivalent amount to the bankrupt free of the creditor's claims.[3]

On review, the district court reversed, holding that under the circumstances the Bankruptcy Act permits the Bank to share equally with the other unsecured general creditors, and that the referee lacked cognizable equitable grounds for subordinating the claim. We agree.

The trustee quite properly concedes that, despite the fact that the trust's claim against the bankrupt is to some extent[4/] secured by his distributive share of the trust, the Bank's claim was properly filed as an unsecured claim. The bankruptcy Act defines a secured creditor as one "who has security for his debt upon the property of the bankrupt of a nature to be assignable under this title" (11 U.S.C. § 1(28)). The bankrupt's interest in the trust is not assignable and not part of the bankruptcy estate; consequently the trust's claim is not secured within the meaning of the Act, and the Bank may file its claim as unsecured. Ivanhoe Bldg. Assn. v. Orr, 295 U.S. 243 (1935).

The remaining question therefore is whether the referee could subordinate the Bank's claim (undoubtedly thereby defeating it).

Subordination is an equitable power. We recognize the principle that a bankruptcy court is a court of equity, charged to apply equitable principles to reach equitable results when administering the Bankruptcy Act. In doing so, the bankruptcy "chancellor" may disregard form for substance and alter the result which would obtain under a formal application of general legal principles, in order to do equity. Pepper v. Litton, 308 U.S. 295 (1939).

Nevertheless, the bankruptcy court's power to impose a result different from that prescribed by the statutory distribution scheme is not unlimited. The standard is that "a claim's disallowance or subordination may be necessitated by certain cardinal principles of equitable jurisprudence." it is important to keep in mind that the chancellor never did, and does not now, exercise unrestricted power to contradict

statutory or common law when he feels a fairer result may be obtained by application of a different rule. Courts of equity have long applied standards of conscience to conduct on an individual basis to prevent formally proper but unconscionable applications of legal rules; they have not engaged in the practice of making abstract legislative judgments about the fairness of a result contemplated by the legislature's statutory scheme if it has otherwise been followed in good faith and without overreaching. See Colonial Trust Co. v. Goggin, 230 F. 2d 634, 636-37 (9th Cir. 1955). As Maitland put it:

> "[W]e ought to think of equity as supplementary law, a sort of appendix added on to our code, or a sort of gloss written round our code, an appendix, a gloss, which used to be administered by courts specially designed for that purpose, but which is now administered by the High Court of Justice as part of the code. The language which equity held to law, if we may personify the two, was not 'No, that is not so, you make a mistake, your rule is an absurd, an obsolete one'; but 'Yes, of course that is so, but it is not the whole truth.'"

Maitland, Equity; A Course of Lectures 18 (1936). Here, the referee in effect said, "No, the distribution scheme provided by the Act is a mistake, the rules of spendthrift trusts and the definition of a secured creditor are absurd and obsolete," and reached a different result.

Whatever the validity of the referee's judgment on the merits of the statutes, a trio of Supreme Court cases dealing with subordination in a closely analogous situation makes clear that he was without power to impose it. In the three

mentioned cases the Court indicated that before a bankruptcy court may disallow or subordinate a claim, some basis must exist of the sort traditionally cognizable by equity as justifying, its intervention, such as fraud, breach of fiduciary duties, mismanagement, overreaching, in fact, any breach of the multitude of "rules of fair play and good conscience" (Pepper v. Litton, supra, at 310) traditionally enforced by a court of equity will suffice. A supposed inequity resulting when an innocent party in good faith asserts a legally valid claim will not. Comstock v. Group of Institutional Investors, 335 U.S. 211 (1948).

In the first two cases of the trilogy, Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939) (The Deep Rock Case), and Pepper v. Litton, supra, the Court subordinated the claims against the controlled corporation, but in each the controlling party engaged in a course of conduct which made it inequitable for it to share in the bankruptcy estate on a par with the other creditors of the subsidiary to whom it owed fiduciary duties. In Pepper the controlling stockholder engaged in an intentional and blatant effort to manipulate corporate forms to avoid the claim of a creditor. In the third case, Comstock, on the other hand, both the district court and the court of appeals concluded that the controlling corporation had managed the subsidiary in good faith and fairly and that the corporation's failure was due to unavoidable business reasons. The Court accepted those findings and held that the parent's claim was properly not subordinated -- thereby allowing the parent corporation to enjoy the benefits of its legally distinct corporate entity and in essence, as here, to file a claim against itself to the detriment of other creditors Compare Comstock, supra, at 229-30, with

Comstock, supra, at 237-39 (Murphy, J., dissenting). See Prudence Corp. v. Geist, 316 U.S. 89 (1942); Frasher v. Robinson, 458 F. 2d 492 (9th Cir. 1972). See A. Herzog & J. Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83, 108 (1961).

Thus, there must be conduct either in acquiring or asserting the claim which is itself inequitable in order to subordinate a claim. Nothing here suggests that inequitable conduct underlies the claims asserted by the Bank. Certainly there is no equitably cognizable overreaching in the Bank's assertion of those claims in the bankruptcy proceeding; the Bank would probably breach its trust to the trust's other beneficiaries if it failed to seek payment of the loans from the bankruptcy estate. (See n. 4 supra.) The parties have not suggested that the trust was either established or administered improperly or with a purpose to prejudice the general creditors, or that the bankrupt's debts to the trust are other than a reflection of good faith business loans. That being the case, the district court properly held that the referee lacked a basis for subordinating the Bank's claim.

As the district court noted, the supposed unfairness here results entirely from the provisions of state law recognizing spendthrift trusts and from the provisions of the Bankruptcy Act giving such trusts effect in bankruptcy proceedings. The Bankruptcy Act advances a number of sometimes conflicting policies. One, of course, is to secure on an equitable basis as much as possible for the general creditors damaged by the bankruptcy. Another, however, is to give the bankrupt a fresh start, allowing him as of the date of cleavage to apply his assets to discharge

his indebtedness and receive anything thereafter free of the claims of creditors. That is what happened here -- the general creditors are no worse off when the Bank Trust department collects its claim against the bankrupt from his assets in the bankruptcy estate than they would be had the notes been payable to another bank (in which case there would be no thought of subordination). The fact that the bankrupt may later receive distributions from the trust, and that the Bank need not collect the debt from the distributive shares, is simply a product of the fact that except for statutorily defined exceptions the Bankruptcy Act dictates that property acquired after the date of cleavage goes to the bankrupt, and that under state law he does not obtain his trust property until the dates set for distribution. See Collier, supra, ¶ 70.26, at 372, ¶ 70.09, at 103 et seq.; Frazier v. Wasserman, 69 Cal. Rptr. 510, 514 (1968). In short, in some circumstances the Bankruptcy Act allows a bankrupt to enjoy his fresh start in life with a silver spoon in his mouth.

The trustee's real complaint here is ultimately with the fact that California law allows property to be tied up in such a manner that the beneficiary may enjoy the benefits of that property without having his interest in that property alienated or burdened to discharge his responsibilities to his creditors. The effects of restraints against alienation have been criticized for centuries; nevertheless, they persist. See Scott, supra, at § 152. Apparently the California legislature saw some value in allowing spendthrift trusts, and the Congress saw some value in providing for enforcement of state rules of property law. A court is not free, in the name

of equity, to override those judgments.

The only other possible basis for subordinating the Bank's claim, the doctrine of marshaling of assets, is clearly foreclosed in the situation here presented under the doctrine of Meyer v. United States, 375 U.S. 233 (1963), which is virtually on all fours.

AFFIRMED.

FOOTNOTES

Page 2 1. Naturally, the beneficiary's portion of the trust not exempted under Cal. Civ. Code § 859 would vest by operation of law in the trustee. See Scott, supra, at 1151. See Matter of Irving Trust Co., 267 N. Y. 102, 195 N. E. 811 (1935). Here, the trustee in bankruptcy, under a stipulated set of facts, has not sought to claim any of the assets in the spendthrift trust, and presumably the beneficiary's share of the estate is entirely exempted by § 859.

Page 3 2. If there were never an intent that the loans be repaid, there would be no debt and hence the issue of subordination would not be raised. The situation is analogous to that involved in distinguishing between a "loan" and a capital contribution made to a controlled corporation. See A. Herzog & J. Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83, 93 (1961).

Page 4 3. The referee ruled that he had no power to impose a constructive trust for the benefit of the general creditors to recoup amounts paid the Bank out of the bankrupt's subsequently acquired distributive shares. That ruling was not challenged.

Page 4 4. It is unclear from the record whether or not the distributive portion of the trust remaining as the bankrupt's share is larger or smaller than his remaining indebtedness. Aside from the possibility that the trust is insecure on that basis, there is always the possibility of a decline in the value of the trust assets. And in the event of the bankrupt's death, the trust provides for a gift over to his heirs which quite plausibly could defeat the trust's recovery under the language of the trust instrument.

Page 10 5. Moreover, ordinarily a party will not be relegated, under the doctrine of marshaling, to one of two funds if recovery from that fund is uncertain. Victor Gruen Associates, Inc. v. Glass, 338 F. 2d 826 (9th Cir. 1964) Here, the trust's recovery from the beneficiary's distributive share imposes on it some risk of loss. See n. 4 supra.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1975

No. _____

In the Matter of ARTHUR CLARKE AHLSWEDE and DOROTHY AHLSWEDE,
Bankrupts.
RICHARD W. STEBBINS, Trustee,
Petitioner,
v.
CROCKER-CITIZENS NATIONAL BANK,
Respondent.

AFFIDAVIT OF SERVICE

STATE OF CALIFORNIA
COUNTY OF SAN FRANCISCO ss

I, Donavon R. Marble, being duly sworn upon oath deposes and says: that pursuant to Rule 33 I have served the within petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit on the counsel for the respondent by enclosing three copies thereof in an envelope, airmail postage prepaid addressed to:

Richard R. Clements, esquire
Crocker Bank Plaza, Suite 700
611 West 6th Street
Los Angeles, California 90017

and depositing same in the United States Mail at San Francisco, California, on August 21, 1975, and further certify that all parties required to be served have been served.

Donavon R. Marble
Counsel for Petitioner